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# China's Overseas Oil and Gas Investment: Motivations, Strategies, and Global Impact by K. Wu

# CHINA'S OVERSEAS OIL AND GAS INVESTMENT: MOTIVATIONS, STRATEGIES, AND GLOBAL IMPACT

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## 1. Introduction

In the mid and late 1990s, China embarked on a path of investing in overseas upstream oil and gas assets and intensified its efforts in the latter part of the decade. Since the beginning of this decade, Chinese state oil companies have made a bigger push to expand overseas, an effort strongly favored and encouraged by the Chinese government. The Chinese state oil companies have thus been taking advantage of the central government's growing concern over potential disruptions to their energy supplies to realize their desires of having larger business operations around the world. "Going out" has become part of the overall investment strategy for every state oil company in China.

China National Petroleum Corporation (CNPC) leads the charge in overseas upstream petroleum investment. CNPC was later joined by its publicly-listed subsidiary PetroChina. China National Offshore Oil Corporation (CNOOC), through its publicly-listed subsidiary CNOOC Limited, has followed CNPC's lead in the pursuit of overseas ventures. China Petrochemical Corporation (Sinopec), together with its own publicly-listed subsidiary Sinopec Corp, comes in third in its overseas energy investment activities. In addition to these three, state oil trading company Sinochem Corporation and two non-oil state companies, China International Trust & Investment Company (CITIC) and ZhenHua Oil Company, have also begun investing in oil and gas overseas.

## 2. Investment Activities Conducted by Various Chinese Players

CNPC/PetroChina currently engages in multiple overseas projects and service contracts, large and small, spreading over four dozen countries. It is also the first Chinese state oil company to invest in the overseas petroleum sector. Oil production from fields that CNPC/PetroChina involved reached 1.1 mmb/d in 2006 and 1.2 mmb/d in 2007. CNPC/PetroChina's equity oil amounted to 561 kb/d in 2006 and is estimated to top 600 kb/d, up from 329 kb/d in 2003 and 400 kb/d in 2005. For natural gas, CNPC/PetroChina's equity output overseas was 368 million standard cubic feet per day (mmscf/d) in 2006, up from 251 mmscf/d in 2004 and 281 mmscf/d in 2005.

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Overall, CNPC/PetroChina's overseas petroleum investment activities concentrate in Africa, South America, Central Asia, and the Middle East, including but not limited to Sudan, Kazakhstan, Venezuela, Indonesia, Algeria, Azerbaijan, Canada, Ecuador, Iran, Syria, Mauritania, Oman, Nigeria, Angola, Russia, Turkmenistan, Uzbekistan, Peru, Iraq, Brazil, Tunisia, Libya, Chad, Mongolia, Myanmar, and elsewhere (see also Wu and Han 2005).

CNOOC's overseas operations began in the mid 1990s. CNOOC's equity oil and other liquids from overseas projects jumped from 24 kb/d in 2005 to 74 kb/d in 2006. The 2006 natural gas output from overseas was 179 mmscf/d, up from 93 mmscf/d in 2005. The overseas output in 2007 is estimated to be higher. Together, CNOOC's overseas oil and gas equity production was 111 thousand barrels of oil equivalent per day (kboe/d). Its target is to raise the combined output to some 400-500 kboe/d by 2010, a rather ambitious goal.

CNOOC currently invests or has interest in investing in Indonesia, Australia, Myanmar, Canada, Nigeria, Iran, Morocco, Kenya, Kazakhstan, Algeria, Iraq, Egypt, Equatorial Guinea, Somalia, Vietnam, Côte d'Ivoire, Nigeria, Gabon, Ghana, and Angola.

Sinopec began investing overseas later than CNPC/PetroChina and CNOOC/CNOOC Ltd. In 2007, Sinopec's equity oil production surged to 140 kb/d, up sharply from 90 kb/d in 2006 and nothing a few years back. The target for 2010 is 200 kb/d. Currently, Sinopec is involved in over 30 overseas oil and gas projects in Iran, Algeria, Saudi Arabia, Kazakhstan, Brazil, Azerbaijan, Canada, Yemen, Egypt, Angola, Russia, Colombia, Oman, Sudan, Myanmar, Nigeria, Gabon, Cuba, Uzbekistan, Liberia, Nigeria, Venezuela, and others.

Sinochem has become the fourth Chinese oil company to pursue overseas investment. In the early 2000s, Sinochem formed its first upstream oil and gas exploration and development company, solely for the purpose of investing in upstream projects outside of China. Compared with the other three Chinese state oil companies, Sinochem's overseas activities are less extensive. Its equity oil production from overseas projects is in the order of 10-15 kb/d at present. However, since 2006 Sinochem has been active in expanding its overseas oil and gas assets in the Middle East, Asia, Africa, South America, and elsewhere.

As far as energy is concerned, CITIC has been investing in powerplants and other power generation efforts, and for the most part their investments have been in China and Hong Kong, though they have, for example, been involved in building power generators for Uzbekistan as part of a political effort to strengthen ties with that country. CITIC's first move overseas is mainly in Kazakhstan.

ZhenHua Oil is a small state-owned company established in 2003. Its business includes overseas petroleum investment, oil trade, and petrochemical investment in China. The parent company of ZhenHua Oil is China North Industries Group Corporation, who has links to the military. ZhenHua Oil's overseas operations include blocks in Syria, Kazakhstan, and Pakistan. Total crude oil production that involves ZhenHua Oil tops 20 kb/d at present.

## 3. Motivations, Unique Characteristics, and Strategies

Three issues are worth exploring in assessing China's overseas petroleum investment: (1) the motivations of the state oil companies to seek overseas investment; (2) the unique characteristics of the overseas petroleum investment by Chinese state oil companies; and (3) their procurement strategies.

In a nutshell, the motives of the Chinese state oil companies can be summarized as follows:[2]

- Continuous Expansion for Survival: In China, state-owned enterprises (including state oil companies) often need to justify their existence and they do it in many ways. Staying big is one way, continuing to expand is another—the larger the company, the more it is able to justify its importance and argue that what is good for it is good for the country. Increasing overseas investment fits into a perennial strategy of continuous expansion.

- Diversification: Though there is still room for expansion, the domestic energy business among the state oil companies is partially governed by a legal division of areas of operation and business scope, and the competition is fierce in other areas. Yet, there is no prescribed limit to the kinds of business operations these state oil companies can invest in overseas. Thus, it is not just the heavyweight petroleum companies like CNPC/PetroChina and Sinopec to which overseas investments are appealing, it is appealing to other state oil companies and non-oil companies, such as CITIC, due to the freedom to maneuver and the opportunity to diversify.

- Seeking International Profits: Although state oil companies that have the government as the dominant shareholder usually have lower expectations than is generally the case of public shareholders, they do not want to lose money either. In many cases the return on overseas investments is bigger than what is available at home, though still lower than the returns recorded by most international oil companies.

- Full Utilization of China's Technologies and Labor Force: After several rounds of streamlining, CNPC/PetroChina and Sinopec/Sinopec Corp, CNOOC, and Sinochem, combined, still have over 2 million employees nationwide. The Chinese oil companies have accumulated decades of indigenous, as well as imported technologies for oil exploration, development, production, and refining. These companies are eager to fully utilize their technologies and labor force in the overseas petroleum sector.

[2] See also Ma (2007).

Given the government's desire to ensure energy and, particularly, oil security, and the motives by state oil companies to expand overseas, China's actual investment moves in the global energy scene are an interaction between what is best seen as two distinct parties. For the most typical cases of overseas energy investments, the state oil companies are often the discoverer of new opportunities and the initiator of the project. They then seek the central government's support in their endeavors, and in most cases such support is quick and strong. In most cases, state oil companies have to rely on their own financial resources to conduct individual projects. However, for large deals, such as Sinochem's attempt to buy the Inchon Refinery in South Korea, CNOOC's attempt to buy Unocal in mid 2005, and CNPC's bid to purchase PetroKazakhstan of Canada, the state oil companies not only needed the central government's approval but the support of state banks as well.

With or without the government support, Chinese state oil companies still have to evaluate the economics of each project or equity investment to determine if it is worthwhile. In fact, because goals for state oil companies vary, and are not limited to the quest for profits, China's overseas oil and gas investments push has these unique features:

- Chinese energy investors may overspend or promise too much just to secure a contract. Chinese companies have outspent rival bidders by large margins to win contracts in Venezuela, Kazakhstan, and elsewhere.

- The high premium that Chinese state oil companies appear to be willing to pay even extends to assets where competition is limited, as in Iran where US-based oil companies are banned from investing. We believe that the willingness to pay this premium arises from domestic political considerations and interagency competition rather than a comprehensive geopolitical strategy directed by the central government. The central government may, in fact, have moved to address this issue, somewhat, by encouraging the different state oil companies to cooperate with each other when bidding internationally for petroleum assets. Chinese investors are willing to go to countries that may be considered risky to major oil companies.

- The Chinese state oil companies, like their counterparts in India and Malaysia, offer a relatively inexpensive source of capital to countries that need it, but are unattractive to the international majors due to insufficient investment returns.

- All Chinese investors in the overseas petroleum industry are state-owned companies. Traditional economic concerns and commercial interests may not be the only driving force behind a decision to invest overseas. The Chinese state oil companies may be strongly motivated by the need to avoid being downsized by the central government's process of economic restructuring.

- Because all Chinese state oil companies have been forming discrete strategies to exploit the central government's concerns over energy security, they are increasingly in competition with each other. Competition between PetroChina and Sinopec was evident in Sudan and Libya, between CNOOC and Sinopec in Brazil, and among all three in Canada, Iran, and elsewhere. Beyond the competition, the presence of multiple state companies from the same country can be confusing to host nations. The Chinese government has begun to encourage cooperation between the three majors on overseas acquisitions in order to address this problem. The September 2005 purchase of EnCana's assets in Ecuador for US$1.42 billion by the Chinese consortium, consisting of PetroChina, Sinopec, and Sinochem in Ecuador, is an example of such an effort.

- Because China is a new player in the global oil business, the Chinese companies are fighting for investment opportunities, and are aggressively seeking to buy equity shares in existing projects or companies globally. The probability of resistance in certain host countries will be high. China has already had several high-profile setbacks in its attempts to buy into energy companies in Kazakhstan, Russia, the US, Canada, and elsewhere for fear of Chinese dominance or unfair investment practices.

In the above context, the procurement strategies of the Chinese state oil companies can be seen as follows:[3]

- Secure oil supplies from key countries such as Saudi Arabia, Iran, Russia, Angola, Sudan, and others. This is done through the government support if possible.

- Take advantage of the government support (including access to credit and easy approval) to expand overseas.

- Take advantage of their labor and technologies availability.

- Justify its own existence through continuous expansion.

- Seek ways to spend the huge monopoly profits earned at home with government protection for overseas investments.

- Seek international profits to make up for policy losses at home from time to time.

- Focus on buying into existing oil and gas assets overseas rather than exploration activities.

- Bid aggressively by taking advantage of their financial strength, the government support, and that expected rates of return are lower than those for international oil companies.

- Tendency to pick countries that are friendly to China and hostile to the west and international oil companies.

[3] See also Yao (2006) and Wu and Storey (2008) for discussions of the broad strategies sought by the Chinese government regarding overseas petroleum investment, oil diplomacy, and energy security.

- Willingness to provide financial aid, infrastructure/education buildup, and/or overall package deals to host countries.

- Compete as well as cooperate with national oil companies from other countries such as India, Malaysia, and Indonesia.

These features and procurement strategies suggest that China's overseas petroleum investments are being driven by a mixture of market-based decisions by state oil companies, the competition between the state oil companies to protect and enhance the central government's regard for them, and the overall push by government policymakers. The extent to which the cabinet and other sovereign agencies of the government are involved in these efforts has varied from case to case. Generally speaking, the highest level decision-making and agenda-setting bodies in China will only become involved in especially large and significant acquisition attempts. Even then, the acquisition target in question will most likely have been decided upon by the state-owned company, independent of the highest authorities. In nearly all cases where financial or diplomatic support will be needed to secure a deal, the state-owned companies will have to lobby the relevant channels of the state in order to receive them.

However, even in those cases where market considerations are the dominant motivation, Chinese state oil companies are bidding more aggressively than international private majors and independent companies. But it should be kept in mind that the considerations driving these efforts by the Chinese state oil companies is similar to those of state oil companies from India, Brazil, and even Malaysia, or state-owned oil companies of countries that are net importers of petroleum.

## 4. Global Impact of China's Overseas Oil and Gas Investments

Overall, China's impact on the global markets through its overseas oil and gas investments is growing very fast. In terms of sheer value and volumes, China's overseas petroleum investments is still limited. Between the early 1990s, when CNPC began investing in Canada and Peru on a small scale, to the end of 2008, China's cumulative overseas investments in oil and gas supply is estimated at well over US$20 billion, with additional billions of dollars committed or planned. The total equity oil secured mainly by CNPC/PetroChina, and to a lesser extent CNOOC, Sinopec, and others, has exceeded 800 kb/d at present, equivalent to roughly around 26% of China's total crude imports in 2007, 23% of China's domestic oil production, 12% of China's current oil consumption, 4% of the current US oil consumption, and 1% of global oil production.[4]

Judged from this perspective, the impact of China's overseas petroleum investments on the global energy markets is limited but taking shape at present, and the impact on China's oil supply is certainly not insignificant. Moreover, China's overseas investments have the potential to grow rapidly in future. By 2010, the total equity oil by Chinese state companies is likely to be in the range of 1.2 to 1.5 mmb/d. Given the stagnation of the

[4] Data used for deriving the share come from BP (2007), FACTS Global Energy (2007), and author's own estimates.

Chinese domestic oil production, the importance of the overseas equity oil is growing. China has contributed to the world oil supply to a certain extent though it is discounted for the direct purchase of existing producing assets.

For a while, China was singled out as the most important country behind the surge in global oil prices. The truth of the matter is that China's demand is indeed growing fast, particularly in 2004, and China is likely to help shape the direction of future oil demand in Asia, as well as the world at large. On the other hand, however, China's appetite for more oil is hardly the only reason why oil prices are high. Global oil prices are determined by a variety of factors including: demand, supply, government policies, technologies in the long term, stock changes, weather conditions, OPEC production quotas, possible supply interruptions, stock market investment activities, and the impact of global terrorism. As such, booming and steady demand is one of many factors driving higher oil prices. For that, China's role is evidently large.

China is currently the second largest oil consumer in the world, but the oil consumption of the US is still three times as large as China's. The impact of China on global oil demand is its rapid growth, an important factor in determining the future strength of world oil demand and its impact on oil prices is the demand growth or incremental demand. For that, China will continue to play a vital role. Our projections show that China's share of the world's incremental oil demand growth may range from 20% at the low end to 40% at the high end over the next ten to fifteen years. Incidentally, the role of the US is also important. As such, it is fair to say that China and the US are the two most important players who will shape the global demand of oil over the coming decade.

Future oil demand is not the only factor determining future oil prices. Technological advancement and upstream investment in the petroleum sector are important in establishing proven oil reserves and future oil production capacity. A lack of investments in the past five or more years is equally responsible for the high oil prices, as is raising oil demand. For the coming decade, if the oil production does not increase quickly enough, as is likely to be the case, oil prices will further increase.

In short, China, along with the US, is expected to lead the growth of global oil demand for the next ten years and beyond. These two countries will also be hurt the most by increasing oil prices. When the oil prices are high enough, its real negative impact on demand is likely to emerge, which will help slow the Chinese, US, and global oil demand growth, and balance the overall oil demand and supply in the long run.

## 5. Concluding Remarks

China's overseas energy investment activities have increased substantially since 2000. With rising oil prices, tighter global oil supply, and the Chinese government's growing concern over energy security, we expect the Chinese state companies to move fast into overseas upstream ventures in the future as they did in the recent past. The competition between the state oil companies of the relatively new net importing countries like Brazil and India will put increasing pressure on the valuation of petroleum assets worldwide, however, that pressure can be alleviated if some sort of cooperation is formed among them, like those between China and India.

Does China's overseas oil and gas investments help promote China's energy security? On the surface, it is always helpful to have more options, as far as energy security is concerned. However, China's push can be costly and it seems unlikely to do much to reduce the Persian Gulf's share and the share of overall oil imports in their energy requirements in the long term. When political and other non-economic considerations (including the desire of the Chinese state oil companies to grow for domestic reasons) are given higher priority, overseas investments could prove to be an expensive and, ultimately, ineffective way of ensuring energy security.

Moreover, the Chinese state oil companies are weak in financial, managerial, and business disciplines. The failure of the Singapore-based CAO is a good example of this phenomenon. However, so far the call for a cool down of the overseas investments has not been especially successful within the Chinese government, though the failure of CAO has created considerable concern. If Chinese investors can reduce the weight of non-economic factors in forming overseas investment strategies and instead take advantage of their rich labor resources and cost-effective, well-developed engineering and drilling technologies, their ventures abroad can be efficient and effective. But Chinese oil companies have a long way to go before reaching the stage where economics, and not internal politics, is the main factor in deciding overseas investment strategies. The Chinese state oil companies also need to be better coordinated to avoid destructive competition amongst themselves, resulting in overinvestment in the same areas and countries.

For the world as a whole, the impact of China's overseas investments is growing fast. Until recently, the overseas investments of Chinese state oil companies were poorly coordinated and complicated by non-economic factors. However, the state oil companies are improving their coordination and the world will continue to see more investments from Chinese state oil companies.

One positive aspect of China's overseas investments is its marginal contribution to the world oil sector investment and global oil supply. However, given a new, high plateau for oil prices of over US$70 (Dubai crude which is more applicable for China) per barrel in the medium to long term, the search for overseas assets by China will push up the price of those assets for all players in the international oil and gas market.

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